Comments of HQ Energy Marketing Inc.

On the

Market Power Framework for the IESO Administered Electricity Market

Introduction

HQ Energy Marketing Inc. ("HQEM") wishes to thank the Market Surveillance Panel ("MSP") for providing market participants the opportunity to participate in the discussions that occurred since the issuance of the ***Market Power Framework for the IESO Administered Electricity Market*** discussion paper ("Framework") and providing the opportunity to submit written comments.

HQEM is a fully registered IESO Administered Electricity Market ("IESO") participant. It is a subsidiary of *Hydro-Québec* and acts as the sole marketing agent in Canada for the *Hydro-Québec Production* division ("HQP"). HQP manages a generation portfolio of more than 40,000 MW of installed capacity, 97% of which is hydro electric generation. The hydro electric generation is a very flexible and valuable regional resource, much of which in the context of multi-year reservoirs and coordinated generation. HQP's first and foremost mission is to serve Québec's native load. The IESO is one of several electricity markets in which HQP may discretionary elect to sell some power surplus. Understanding the interaction between this native load responsibility and the multi-year nature of the HQP hydro electric system is key in considering the decision making and associated opportunity costs of HQP and HQEM. This unique and important perspective is reflected in the comments below.

Following its active participation, HQEM wishes to express the following observations on the Framework and its related presentations.

General Observations and Comments

First, as a fully registered IESO market participant, HQEM is allowed to sell at "market-based rates", rather than inapplicable traditional "cost-of-service rates" or "cost-based formulas". Some aspects of the Framework would actually result in pricing more similar to such cost-based rates, which in general are non-compatible with the contemporary pricing and market design environment.

Second, HQEM wishes to reiterate that, despite official claims to the contrary by the MSP, it is extremely concerned that several of the basic principles that support this Framework could eventually, and inappropriately be converted into market compliance rules. The uncertainty of potential future mitigation authority, mitigation application and its outcome, in the short term, will discourage market participation and, in the long run, discourage needed capital investment and ultimately raise prices.

Third, we have not witnessed or heard any form of stakeholder support either for the Framework or for its underlying principles. This fact alone should be of concern to the MSP.

Fourth, other structured electricity markets have specifically excluded hydro and external resources from their market power assessment and mitigation process. They have done so in recognition of the complex nature of reservoir management and the associated measurement of opportunity costs, as well as the voluntary nature of sales from external resources. It is fundamentally irrational to attempt to mitigate prices from parties who have no obligation to sell in the IESO market in the first place, and whose participation is totally voluntary. Actions to mitigate energy sales from such resources presume that IESO has some form of call on these resources or that such resources are somehow obligated to the IESO market. This simply isn't true. As a result, the net effect may be to occasionally reduce prices for such purchases, but at a cost of being virtually assured that such supplies will be eliminated at times when they are needed most.

Fifth, as HQEM and others have stated during face-to-face meetings with IESO, there is no evidence of any significant exercise of market power within the IESO. This is a conclusion that the MSP has repeatedly reached in past reports. Upon announcement the proposed Framework, the MSP said that the Framework will help "*(...) us to understand and explain unusual price movements.*" Although there is no denying that, as with any other electricity market, "*unusual price movements*" occur from time to time, there is no reason that one must conclude that they occurred as a result of the exercise of market power rather than as a result of general and dynamic market conditions and/or market design. Certainly this should be presumed to be the case in general, and in specific for voluntary external sales.

In the following sections, we comment further on:

1) Economic Considerations;
2) Lack of Obligation to Sell—Territorial Considerations;
3) Opportunity Costs and other Pricing Considerations.

1) Economic Considerations

For most commodities, the demand goes down as price goes up. Not so with electricity; because of the intermediary retail market rate designs and the lack of overall price transparency to consumers, demand typically does not respond much to higher short-term price spikes. There is little, if any ability, to reduce consumption based on cost or price signals under the current retail market structure.

This is what the economic theory designates as *inelastic demand*. At times of scarcity, demand doesn't see transparent prices and as a result it will not be "disciplined" by price. Inevitably, when demand grows, prices rise. The failure of most users of electricity to see

real-time prices means that there is a higher likelihood of price spikes at times of actual scarcity, as the scarcity is not seen or ignored by power consumers.

In a fully-functional market, a highly flexible external generator with very responsive ramping capability, (e.g. the 5-minute response capability of a hydro-based system like HQP), is uniquely positioned to provide supply in scarcity conditions. It should be allowed to reap the full benefit of its operational advantages over its competition, regardless of his bidding history. If the HQP resources have significant value, IESO should purchase them at the offered price. If not, IESO should select other resources. Similarly, HQP as a voluntary participant should be free to offer or not offer the resources at a price of its choice absent some other arrangements that would obligate HQP to make supplies available (e.g. a long term contract which includes a premium for the certainty of supply associated with such an agreement).

No one can deny that Ontario has experienced episodes of tight-supply conditions since market opening, resulting in scarcity conditions and hence, "unusual price movements". Similarly, voluntary purchases from HQP at prevailing prices during such periods are indicative of mutual agreed prices, nothing more.

It is HQEM's position that once scarcity is observed, whether being locally or system-wide, it should not warrant further analysis with respect to the pricing of voluntary external resources. Both buyer and seller are free to purchase and sell to others and neither has any *ex ante* obligations to the other.

Contrary to a fully-functional market, there is a genuine attempt in the Framework to exercise control over spot prices and negate volatility, and especially in tight-supply conditions, to attenuate scarcity and investment signals by mitigating the price signals from voluntary sales.

As a result, the implementation of the Framework would likely reduce import offers into Ontario, as external suppliers will be under compensated to the extent that IESO attempts to impose pricing lower than that offered voluntarily.

The MSP should dedicate its resources and efforts to identify market power acquired through illegal means or directed towards illegal ends.

2) Lack of Obligation to Sell—Territorial Considerations

There is simply no basis upon which IESO could or should reasonably have any reliance or expectation that its demand must be met through HQP resources, or that in turn, HQP should have any obligations to the IESO market. Similarly, without such reliance, the only circumstances upon which IESO would be expected to purchase power from HQP and HQEM are when the HQP resources are priced advantageously in comparison to the resources that IESO has chosen to rely on.

i) Jurisdictional and Market Rules Considerations

By nature, external supply is and should remain voluntary. To some extent however, the Framework tries to regulate assets located outside of Ontario. Such an extra-jurisdictional extension of its rules is unacceptable and certainly raises serious legal issues.

This voluntary dimension fundamentally differentiates importers from internal generators and as such, they should be treated differently. Each voluntary involvement should therefore be viewed as a separate action, with no linkage to previous "episodes" of voluntary efforts or contributions.

Moreover, being voluntary, an external supplier cannot be deemed necessary for reliability especially since there is no payment for calls or capacity in the IESO. An obvious outcome of the Framework would be to effectively create a capacity obligation for importers, even in the absence of a capacity market within Ontario.

Given its voluntary nature and its several competing selling options, common sense dictates that imports will likely play an incremental supplier role, being purchased only when they are cheaper than alternative resources that Ontario has reason to rely on. In this context, the only result of such purchases would be to lower prices for Ontario below what they otherwise would have been.

It should also be emphasized that in regions that do have a capacity market, a capacity obligation from an external resource typically results only in an obligation to offer energy below the market designated price cap. This obligation is a direct exchange for the separate capacity related compensation. It is at the discretion of the seller to set the energy offer price. Unless otherwise desired by the seller, only in extreme conditions (scarcity, high prices) do these high energy bids from capacity resources clear economically and the capacity call is exercised.

HQEM would like to reiterate a point we made during face-to-face meetings: as proposed, certain aspects of the Framework will result into a free call option on our resources at a price capped below the market price cap, without even paying any capacity payment. This is an irrational constraint for voluntary external sales. If the price is too high, IESO simply can refuse to purchase the power, and make do with its own internal resources, or they can make long term commitments to external suppliers, with a capacity payment, and negotiate for lower energy prices from such resources.

ii) Imports and Economic Withholding

The Framework has determined that the concept of physical withholding of supplies would not be applicable to imports, recognizing their voluntary nature.

HQEM is of the position that importers should also be excluded from the application of economic withholding as well. Being voluntary supplies, once accepted and hence deemed economical, imports should actually contribute to lower the anticipated HOEP that would have been otherwise higher, absent of such voluntary import supply. Again his

contribution would be beneficial to the market, regardless of its bidding history. Further, as discussed above, the notion of economic withholding simply doesn't make sense in the context of a voluntary external supplier, any accepted price by definition is lower than IESO could or would receive for internal resources, therefore all purchases reflect a realized savings to IESO power purchasers.

It is also HQEM's position that a market bid cap fully addresses any economic withholding issue. An importer should be allowed to sell into an adjacent market at any price (up to the market price cap) that market conditions dictates, regardless of its past bidding pattern.

3) Opportunity Costs and other Pricing Considerations

HQP's bidding strategy is complex and reflects a number of factors, most of which are very relevant, legitimate in terms of the resulting pricing, and totally ignored in the proposed Framework.

As a government-owned utility and due to its primary load serving function, HQP bears considerable, unique and ever-changing risks and obligations: probability of spill, water-level (i.e. energy) risk, maintenance requirements, future obligations different than expected, hydro coordination (optimize the generating output from a number of coordinated hydroelectric projects on several river systems) and non-power constraints (irrigation, flood control, wildlife, recreation and navigation, etc.). All of this is superimposed over the general obligation to reliably serve native load while at the same time minimizing costs to its provincial customers while maximizing its contribution to overall revenues remitted to the government of Québec.

As a starting point in such a bidding strategy, HQP also bears the risk of assessing future energy market prices, the demand for power by its native load, the potential to "recharge" its reservoirs, and its ability to "move" power over time. All of this is inherent in an operating entity with a hydro generation system with significant multi-year storage operating in an integrated manner over a regional watershed.

Therefore, at minimum, its decision to dispatch its output in order to support sales to other markets is driven by opportunity costs that reflect trade-offs that potentially occur over seasons, if not years, i.e. the value of future generation that the stored water (i.e. energy) could provide. HQP's opportunity and ability to store water up to several years introduces a time dimension that the Framework simply ignores.

In addition, in making such sales to external parties, HQP must not only consider the direct opportunity costs it faces based on this type of inter-temporal trade-off, but also the subjective risk elements associated with its obligations to native load.

Conclusion

There are several concepts contained in the Framework that negates several fundamental components of any efficient market model.

HQEM respectfully submits these comments for the consideration of the MSP.

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